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SUBJECT: PREVIEW OF EDRC ANNUAL REVIEW OF CANADA, JUNE 4

REF: OECD DOCUMENT EDR(75)11

1. SUMMARY: SECRETARIAT SURVEY OF CANADIAN ECONOMY NOTES THAT "1975 MAY BE A DIFFICULT YEAR," WITH GNP FALLING 1.4 PERCENT, UNEMPLOYMENT RISING TOWARD 8 PERCENT LEVEL, CONSUMER PRICES INCREASING AT 11.8 PERCENT RATE, AND CURRENT ACCOUNT DEFICIT EXPECTED TO REACH \$6 BILLION. IT NOTES THAT RATE OF INFLATION IS NOT DECLINING IN RESPONSE TO RISING UNEMPLOYMENT. DESPITE GIVING THIS PESSIMISTIC OUTLOOK, SECRETARIAT CONCLUDES THAT POLICY STANCE SHOULD BE EVEN MORE EXPANSIONARY, REGARDLESS OF IMPACT ON CURRENT ACCOUNT AND INFLATION, TO OFFSET EXPECTED NEGATIVE GROWTH OF OUTPUT AND HIGH LEVELS OF UNEMPLOYMENT. SECRETARIAT DOWNPLAYS SERIOUSNESS OF CURRENT ACCOUNT DEFICIT AS BASICALLY CYCLICAL PHENOMENON WHICH CAN READILY BE FINANCED VIA CAPITAL INFLOWS. ACTION REQUESTED: COMMENTS AND QUESTIONS FROM OTTAWA AND WASHINGTON IN TIME FOR ANNUAL REVIEW JUNE 4. FOR LIMITED OFFICIAL USE
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EXAMPLE, SHOULD WE QUESTION SECRETARIAT'S CONCLUSIONS AND ASK WHETHER CANADA SHOULD NOT AWAIT BETTER PERFORM-

ANCE ON PRICE AND WAGE FRONTS BEFORE GIVING FURTHER STIMULUS TO DOMESTIC ECONOMY, PARTICULARLY GIVEN PROSPECTS OF EXTERNAL STIMULUS FROM EXPECTED RECOVERY IN TRADING PARTNER COUNTRIES. END SUMMARY.

2. GENERAL OUTLOOK: SECRETARIAT EXPECTS 1975 TO BE DIFFICULT YEAR FOR CANADA, WITH ONLY MODEST RECOVERY IN ECONOMIC ACTIVITY DURING SECOND HALF OF YEAR AND FIRST HALF OF 1976. SECRETARIAT DOES NOT SEE RETURN TO CAPACITY GROWTH RATES UNTIL THERE IS SUBSTANTIAL UPTURN IN WORLD ECONOMY, AND SUGGESTS THAT RECOVERY WILL PROBABLY NOT BE SUFFICIENT TO PREVENT CONTINUED RISE IN UNEMPLOYMENT TO OVER 8 PERCENT BY MID-1976. GNP EXPECTED TO DECLINE BY 1.4 PERCENT IN 1975. SECRETARIAT ATTRIBUTES SLOWER GROWTH OF OUTPUT IN 1974 AND 1975 LARGELY TO SHARP DECLINE IN FOREIGN BALANCE DUE TO WEAKNESS IN DOMESTIC ACTIVITY IN U.S. AND ELSEWHERE, AND FALL IN INVESTMENT IN RESIDENTIAL CONSTRUCTION. PRIVATE CONSUMPTION EXPECTED TO BENEFIT TEMPORARILY FROM INCOME TAX CUTS, BUT AFTER ONE-SHOT STIMULUS OF TAX REFUNDS IN SECOND AND THIRD QUARTERS' PRIVATE CONSUMPTION WILL REVERT TO BASICALLY FLAT RATE OF GROWTH. SECRETARIAT CONSIDERS IT LIKELY THAT SAVINGS RATIO WILL CONTINUE TO RISE IN RESPONSE TO EMPLOYMENT UNCERTAINTIES AND AS A RESULT OF LAGS IN EXPENDITURE AFTER PERIOD OF RAPIDLY-GROWING PRICES AND EARNINGS. PRIVATE NON-RESIDENTIAL INVESTMENT IS FORECAST TO REMAIN RELATIVELY STRONG IN 1975 ESPECIALLY IN ENERGY-RELATED AREAS. RESIDENTIAL CONSTRUCTION IS EXPECTED TO DECLINE UNTIL THIRD QUARTER OF 1975, WHEN STRONG RECOVERY IS ANTICIPATED. THERE IS EVIDENCE OF INVOLUNTARY INVENTORY ACCUMULATION CONTINUING, AND SECRETARIAT EXPECTS DOWNWARD ADJUSTMENT LATER IN YEAR.

3. PRICE OUTLOOK: SECRETARIAT EXPECTS CONSUMER PRICES TO RISE AT 11.8 PERCENT RATE IN 1975, WITH SOME DECELERATION IN FINAL QUARTER AND FIRST HALF OF 1976. INFLATIONARY TREND REMAINS STRONG LARGELY DUE TO UPWARD PUSH FROM WAGE DEMANDS, ALTHOUGH OFFSET IN PART BY WEAKER LIMITED OFFICIAL USE
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DOMESTIC DEMAND AND MORE STABLE FARM PRICES. SECRETARIAT EXPECTS CONTINUED WAGE PRESSURES TO COMPENSATE FOR PAST LOSSES IN REAL INCOME, AND BELIEVES THAT STATUTORY CONTROLS WOULD BE ADVISABLE IF PRESENT VOLUNTARY INCOMES POLICY IS NOT EFFECTIVE.

4. POLICY STANCE: SECRETARIAT NOTES THAT COMBINATION OF WEAK DOMESTIC DEMAND AND ACTIVITY, RISING UNEMPLOYMENT, CONTINUING STRONG INFLATIONARY PRESSURES AND LARGE EXTERNAL DEFICIT POSE DIFFICULT PROBLEMS FOR ECONOMIC

POLICY. GIVEN EXISTING DEGREE OF SLACK, SECRETARIAT BELIEVES THAT STIMULUS TO DEMAND AIMING AT RATE OF GROWTH CLOSER TO CAPACITY LEVEL (OVER 5 PERCENT) WOULD BE UNLIKELY TO ENDANGER PROGRESS ON PRICE FRONT. IT SUGGESTS THAT IMPROVEMENT IN PRODUCTIVITY MIGHT EVEN

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HELP TO REDUCE COST AND PRICE PRESSURES. IT ALSO CONSIDERS THAT MEASURES TO STIMULATE DEMAND COULD BE IMPORTANT ELEMENT IN BRINGING ABOUT ACCEPTANCE OF VOLUNTARY PRICE AND INCOMES POLICY, AND COULD CONTRIBUTE TO NECESSARY CONSENSUS ON NEED FOR WAGE RESTRAINT. SECRETARIAT DOES NOT RECOMMEND MAJOR ROLE FOR MONETARY POLICY IN VIEW OF NEED TO MAINTAIN INTEREST RATES AT LEVELS SUFFICIENT TO INDUCE CAPITAL INFLOW TO COVER EXTERNAL DEFICIT. IT ALSO SEES LITTLE PROSPECT FOR FURTHER STIMULUS FROM TAX REDUCTIONS, SINCE THESE WOULD VERY LIKELY BE RETAINED AS PRECAUTIONARY SAVINGS IN TIME OF RISING UNEMPLOYMENT. SECRETARIAT CONSIDERS THAT STIMULUS SHOULD BE DIRECTED TO RESIDENTIAL CONSTRUCTION AND

TO FIXED INVESTMENT, BUT DOES NOT MAKE SPECIFIC RECOMMENDATIONS FOR ACHIEVING THIS.

5. BALANCE-OF-PAYMENTS OUTLOOK: SECRETARIAT ESTIMATES THAT CURRENT ACCOUNT DEFICIT MAY REACH \$6 BILLION IN 1975, BUT DOES NOT THINK THAT CANADA WILL EXPERIENCE DIFFICULTY IN FINANCING DEFICIT OF THIS SIZE. SECRETARIAL LIMITED OFFICIAL USE

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TARIAT STATES THAT MAIN CAUSE OF DEFICIT IS VERY SHARP FALL IN EXPORTS TO U.S., JAPAN AND OTHER MARKETS EXPERIENCING DECLINE IN ECONOMIC ACTIVITY. IN ADDITION, CANADA'S TERMS OF TRADE ARE EXPECTED TO CONTINUE TO DETERIORATE THROUGHOUT 1975, ESPECIALLY DURING FIRST HALF WHEN IMPORT PRICES EXPECTED TO RISE TWICE AS FAST AS EXPORT PRICES. ALTHOUGH CURRENT ACCOUNT DEFICIT WILL BE ALMOST 4 PERCENT OF GNP, SECRETARIAT DOES NOT CONSIDER THIS TO BE MAJOR CONSTRAINT ON DOMESTIC DEMAND POLICIES. IT POINTS OUT THAT CANADA HAS TRADITIONALLY HAD CURRENT ACCOUNT DEFICIT, AND PRESENT DEFICIT IS LARGELY RESULT OF CYCLICAL FACTORS WHICH WILL BE SELF-CORRECTING AS WORLD ECONOMY BEGINS TO RECOVER. SECRETARIAT DOES NOT THINK THAT EXCHANGE RATE DEPRECIATION IS APPROPRIATE RESPONSE TO EXTERNAL DEFICIT BECAUSE OF ITS INFLATIONARY IMPACT ON DOMESTIC ECONOMY. SECRETARIAT DOCUMENT IMPLIES THAT CANADA SHOULD ACCEPT PROSPECT OF LARGE DEFICIT AND OBTAIN FINANCING FOR IT, RATHER THAN SEEK TO REDUCE DEFICIT BY RESTRAINING DOMESTIC ECONOMIC GROWTH OR PERMIT EXCHANGE RATE DETERIORATION AT COST OF GIVING FURTHER STIMULUS TO INFLATION.

6. MISSION SUGGESTS SECRETARIAT MIGHT BE QUESTIONED ON ASSUMPTION THAT STIMULATION OF DOMESTIC ECONOMY IS FIRST PRIORITY FOR CANADIAN ECONOMIC POLICY AT PRESENT CONJUNCTURE, PARTICULARLY GIVEN LACK OF SUCCESS SO FAR IN CONTROLLING INFLATION. ANOTHER POINT COULD BE TO EXPRESS DOUBTS THAT SECRETARIAT PRESCRIPTION FOR LINKING DEMAND STIMULUS WITH VOLUNTARY INCOME RESTRAINT IS LIKELY TO BE EFFECTIVE IN CANADIAN CONTEXT. (WE SUSPECT THAT INSTITUTIONAL FRAMEWORK IS NOT SUCH AS TO ASSURE THAT LABOR UNIONS CAN LIVE UP TO ANY AGREEMENT ON WAGE RESTRAINT AS QUID PRO QUO FOR DEMAND MANAGEMENT STIMULUS. SECRETARIAT ASSUMPTION OF SUCCESSFUL TRADE-OFF IS APPARENTLY BASED ON SCANDINAVIAN EXPERIENCE WITH INCOMES POLICIES. WE COULD POINT TO RECENT JAPANESE WAGE NEGOTIATIONS, DURING WHICH JAPAN POSTPONED EXPANSIONARY DEMAND MANAGEMENT POLICIES BECAUSE IT FEARED THESE WOULD GIVE FURTHER IMPETUS TO WAGE DEMANDS.) ON BALANCE OF PAYMENTS, MISSION MIGHT QUESTION CANADIAN PLANS FOR FINANCING CURRENT DEFICIT, PARTICULARLY THEIR BORROWING PLANS IN

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7. ACTION REQUESTED: MISSION WOULD APPRECIATE COMMENTS AND QUESTIONS FROM WASHINGTON AND OTTAWA IN TIME FOR ANNUAL REVIEW. ALTHOUGH U.S. IS NOT EXAMINING COUNTRY THIS YEAR, WE ANTICIPATE LIVELY DISCUSSION WITH CANADIAN DELEGATION HEADED BY DAVID SLATER, AND CAN EXPECT HIM TO GIVE USUAL FRANK AND INFORMATIVE RESPONSES TO EDRC QUESTIONS.

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